(ii) **The "productivity factor" in the rate adjustment formula should reflect the high productivity levels achieved and achievable by LECs in an industry and era characterized by rapidly developing technology.**

The calculation of an historical productivity factor based on actual LEC data for the post-divesture era is a critical component in the determination of an appropriate X factor. In general, capital intensive industries, such as telecommunications offer potential for greater than average productivity gains when compared to labor intensive industries such as health care and education. In telecommunications, advances such as digital switching, fiber optic transport, and advanced signalling technologies, have provided LECs with enormous opportunities for productivity enhancements, translating into cost reductions which can, and should, be passed on to business and residential customers -- reductions which would be passed on under competitive market conditions. With expected further price reductions and increased capabilities associated with telecommunications system components such as semiconductors, computers, switches, software and other capital goods, the technology-driven productivity enhancement trend in telecommunications should continue. However, by accepting the assumption that LEC input prices are growing faster than the general output price inflation rate represented by the GNP-PI, the existing price caps productivity offset ignores these important productivity gains. Accordingly, a correct representation of LEC output price changes must combine the historic productivity growth rate achieved by the LECs with the productivity gains reflected in LEC input prices. With respect to historic productivity growth, the formula should be represented as GNP-PI, minus the input price differential, minus the historic LEC productivity growth rate.[19]

The target productivity component of the X factor selected by the Commission is extremely important because if it is set too low (i.e., at a level that consistently understates productivity gains achievable by the LECs), the price cap adjustment mechanism will fail to stimulate a competitive result, allowing LECs to increase prices even where increases in input price levels are less than productivity gains. By comparison, a company operating in a competitive market in such circumstances would be forced to either freeze or reduce its prices. In short, an excessively low X factor will result in excessively high rates for business and residential subscribers.

Available empirical evidence suggests that the average LEC productivity rate is significantly greater than the 3.3% factor now used in the LEC price caps formula. The Commission should recognize this evidence and increase the currently employed unreasonably low X factor.[20]

19/ Normally, the productivity concept is based on total factor productivity (TFP) which incorporates changes in all inputs (capital, labor and materials) simultaneously.

20/ ETI's seven-state study indicates an X factor of at least 5.8%. ETI Analysis, p. 58, fn. 105, and page 59 Table 6.

(iii) **<u>The price cap formula should include a "stretch" factor to account for the effects of price cap program induced economic benefits and to incent LEC efficiency</u>.**

Methods using historical productivity studies to determine the productivity factor suffer from the inherent infirmity of being unable to capture the beneficial effects on LEC efficiency and productivity flowing from alternative incentive-based regulation which post-dates the historical data. Moreover, the productivity factor as a general matter should be set so as to encourage improvement in overall LEC efficiency and to recognize the beneficial effects of alternative regulation in stimulating further productivity gains. The stretch component should be applied as a further offset to the GNP-PI inflation index. Combining all three components, the formula would then be represented as the GNP-PI, <u>minus</u> the input price differential, <u>minus</u> the historic LEC productivity growth rate, <u>minus</u> the stretch component.[21/]

(iv) **<u>Consistently high LEC earnings evidence that prices exceed "competitive result" levels</u>.**

Although the price caps regime was intended to allow LECs to retain a substantial portion of profit increases as a reward for bringing about efficiency gains, the fruits of efficiency gains in competitive markets are at best temporary because eventually other firms will emulate the efficient producer or initiate their own efficiencies. Therefore, if price

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[21/] Application of this formula is detailed in the technical discussion presented in the ETI Analysis at pp. 56-65.

caps are intended to "replicate the marketplace forces of competition"[22] (i.e., achieve a "competitive result"), it cannot be a goal of price cap regulation that LECs retain achieved levels of profit growth indefinitely. And, since excessive profits are not sustainable over an extended period of time in competitive markets, consistently high LEC earnings levels serve as clear evidence that LEC prices exceed "competitive result" levels. In other words, consistent LEC high earnings levels are a clear indicator that the price cap system is not working as it was (or at least should be) intended.

There is ample evidence that RBHC profit levels grossly exceed reasonable capital attraction needs. One example cited in the ETI Analysis compares new investments made by the RBHCs in their BOC subsidiaries ($13.5 billion) to their investments in non-BOC subsidiaries both here and abroad ($21.1 billion) since divestiture.[23] In just the three years since LEC price cap regulation took effect, net BOC investment stands at $564 million while some $11 billion has been invested in non-BOC ventures. As further discussed in the ETI Analysis, LECs may employ a number of devices to effectively convert excessive profits into other forms of cash flow, and it is not necessarily easy to distinguish whether excessive price increases or improved efficiencies account for a growth in profits. It is therefore critical that the Commission not limit its review of the LEC price cap plan to

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[22] NPRM at ¶ 12.

[23] ETI Analysis, p. 68.

"surface-level" financial reports, but that it delve well below the surface to acquire a full and detailed understanding of how the system is actually working. The Ad Hoc Committee believes that if the Commission does so, it will find that fundamental changes are necessary if price cap regulation is to remain a viable and sustainable approach in the future.

F. Baseline Issue 4: The Sharing And Low-End Adjustment Mechanisms Continue To Be Essential And Should Be Retained, But The Commission Should Re-examine The Relationship Between The "Triggers" And Capital Costs.

The rationale for sharing remains as valid today as it was three years ago when the LEC price cap plan was adopted: it establishes a means by which ratepayers may directly benefit from efficiency gains stimulated by incentive-based regulation; and it serves as a safety net for consumers, reducing the impacts of potential errors in setting the productivity factor and resulting in at least a partial return of any excess monopoly earnings that might be accumulated by the LECs.[24/] There is also no basis for revising the 50/50 sharing proportion in the basic sharing band, and requiring a 100% return of earnings in excess of the basic sharing range remains the most straightforward and effective means for protecting ratepayers from overearnings extremes.

The Ad Hoc Committee agrees with the Commission's observations concerning the lower interest rate levels now

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[24/] Competition in the provision of interstate access services has not progressed sufficiently to serve as a full effective market-based safety net for consumers.

prevailing,[25] and urges a reexamination of the relationship between capital costs and the sharing and low-end adjustment triggers. Because of the absence of effective levels of competition in the provision of interstate access services, LECs have no incentive to flow through their reduced capital costs in the form of reduced prices for their customers. In short, the price cap plan should not permit LECs to retain such capital market induced windfall profits. The benchmark rate of return used for setting the sharing and low-end adjustment triggers should be reset downward.

G. Baseline Issue 6: The Commission Should Narrow And Strictly Define The Scope Of Exogenous Cost Adjustments

The Ad Hoc Committee fully agrees with the Commission's conclusion that it "should reduce the categories of cost changes eligible for exogenous treatment."[26] The Committee also supports the Commission's expressed belief that "it would be more consistent with the incentives of a price cap plan to treat only economic cost changes as eligible for exogenous treatment [and that such treatment would] also be more consistent with one of the goals of price caps, to replicate the operation of competition."[27] Indeed, in order to more effectively emulate the functioning of a competitive marketplace, the exogenous cost exception must be tightened to exclude all but those economic

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25/ NPRM at ¶ 54.

26/ NPRM at ¶ 64.

27/ Id.

changes that are directly attributable to well defined regulatory actions specifically and uniquely affecting LECs. Examples of such changes would be jurisdictional cost shifts and certain other accounting related changes. The Ad Hoc Committee further urges that the key issue in evaluating claims for exogenous cost treatment should not be the magnitude of the impact of the change upon a LEC, but how a cost change of the same type would likely be responded to by nonregulated firms in competitive industries. Such an approach will demonstrate that many "unforeseen cost changes", even where "beyond management control", cannot be automatically passed through to consumers.

The Ad Hoc Committee also shares the Commission's concern that LECs generally initiate requests for exogenous cost changes "and have substantial incentives to report and request exogenous treatment only for those that might generate increases in the cap, not those that might justify reductions."[28/] This concern is heightened by the fact that exogenous cost changes that would increase LEC costs tend to be readily identifiable, direct in their impact, and relatively large. In contrast, events which would lead to cost decreases are often indirect, far more difficult to identify, and individually small, even though their cumulative effect can be substantial.[29/]

28/ NPRM at ¶ 65.

29/ An example of how the resultant upward bias in favor of exogenous cost increases (and against the interests of ratepayers) works in relation to LEC costs for state taxes is discussed in the ETI Analysis at p. 80.

If the price caps regime is to achieve the "competitive result" goal set by the Commission, LECs should have no more protection from unexpected cost increases than firms operating in competitive markets. In competitive markets, businesses face a myriad of conditions that could be described as "exogenous" and "beyond their control" on a daily basis, and are able to survive without the kind of cost protections LECs seek through Z-factor adjustments. Successful firms protect against such contingencies through insurance, reserve funds, effective forecasting and planning, and prudent management. Under the competitive market standard, an appropriate test for exogenous cost treatment should inquire whether a particular type or category of event could have been anticipated and planned for by management, not whether the specific event could have been predicted in advance.

H. Baseline Issue 7A: The Commission Should Continue To Monitor Service Quality and Network Reliability.

The Commission would be well advised to monitor service quality and network reliability without regard to whether it regulates LEC rates pursuant to price caps or a rate base rate-of-return regulatory scheme. Reliable telecommunications has become too important to the nation's economy for the Commission to take a laissez faire approach. Arguably, a price caps regulatory scheme might create a condition in which profit pressures cause carriers to compromise programs which are needed to maintain high service quality and reliability. That condition seems not to have occurred to date. Indeed, the LECs' very healthy profit pictures suggest that there has not been the kind of pressure which would compromise service quality.

Even though LECs continue to provide high quality service under price caps, the Commission should view service quality monitoring as an early warning system to guard against gradual network degradation. While, the Ad Hoc Committee does not anticipate such gradual degradations, the Commission should not run even a remote risk that failure to monitor service quality could be viewed in the future as akin to the governmental policies which some blame for the savings and loan debacle if service quality does deteriorate, particularly when the cost of a monitoring program is likely to be very low. Completion and periodic submission of service quality forms to the Commission is hardly a crushing burden.

I. Baseline Issue 8a. The Commission's Price Caps New Service Rules Do Not Impede The Development And Introduction of New Services.

The LECs are de facto monopolists, especially with respect to services which are provided over the public switched network. In the absence of effective competition, Commission oversight is necessary to protect consumer interests. The requirement for Commission oversight is articulated in section 201 of the Communications Act of 1934, as amended, which mandates that rates for services subject to the Commission's jurisdiction be just and reasonable. The current requirement that LECs submit adequate cost justification for new services is absolutely necessary to give meaning to the requirements of section 201. The Commission could not reasonably find that it can rely on the operation of the marketplace to assure that LEC new service rates are just and reasonable. Without cost data, the Commission would be in no position to assess the reasonableness of proposed rates for new LEC services.

LECs cannot reasonably argue that the requirement that rates for new services be cost-based incents them not to offer new services. The Commission's Rules already allow the LECs to attempt to justify new services rates which include risk premiums. These rules give the LECs the same type of incentive that unregulated companies have. Elimination of the cost support requirement would allow the LECs to price gouge their customers. In other words, LECs could earn exploitative returns from some customers if those customers perceived high enough value in the new service offering. This kind of value of service pricing previously has not been and should not now be, sanctioned by the Commission.

J. Baseline Issue 8b: The Price Caps Rules Need To Be Modified To Encourage Innovations And Reasonable Rates.

Implicit in issue 8b of the NPRM is the notion that allowing the LECs to earn higher returns or giving them more flexibility to price new services as they wish without regulatory oversight might be advisable as a means of encouraging new, innovative offerings. Such thinking, however, overlooks the fact that real competition, not exploitative monopoly pricing, is the most likely source of innovation. The ETI Analysis points out that the Commission long ago concluded that monopolists are not likely to develop specialized applications that enhance efficiency and productivity.[30] Monopolists move slowly and develop services and products that are aimed at the mass market. They simply are not good at identifying the niche applications which grow to be more broadly accepted. The Commission again should bet on competition, not monopoly as the best means for encouraging innovation. This is another aspect of the competitive condition that the Commission should strive for through its Price Caps Rules. Indeed, allowing LECs to offer functionalities without sufficient cost support, or to delay submitting cost support, could work against other entities using network based functionalities, such as call control functionalities, to offer new innovative services.

K. Baseline Issue 9a: The Commission Should Not Equalize The Treatment Of LEC And CAP Access Charges For Purposes Of Calculating AT&T's Exogenous Access Costs.

The Commission should not equalize the treatment of LEC and CAP access charges for purposes of calculating AT&T's exogenous access costs because equalized treatment would produce no perceptible benefit for end users and would be inconsistent with the logic that lies behind the Commission's exogenous cost adjustment policy. The ETI Analysis notes that AT&T purchases approximately ninety-nine percent of its access services from LECs, with only about one percent acquired from CAPS[31]. Under

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[30] ETI Analysis, pp. 87-88.

[31] ETI Analysis, p. 90.

these conditions, no economic benefit will flow to end users by requiring AT&T to treat as exogenous the access cost savings for Basket 1 services which it might realize as a result of moving access traffic from LECs to CAPs.

Even if CAPs held a much more significant share of the access service market, the Commission should not require exogenous cost treatment of the Basket 1 savings which AT&T would realize from moving access traffic from LECs to CAPS because such savings are the result of precisely the type of cost-cutting behavior that the Commission hoped to incent though price caps regulation. The cost savings are the result of AT&T's initiative, rather than cost savings from regulatory action beyond AT&T's direct control.

L. Baseline Issue 9b: The Commission Should Not Amend Any Other Rules That Relate To LEC Price Caps Regulation To Equalize Treatment Of LECs And CAPs.

It is preposterous to even consider equalizing regulatory treatment of LECs and CAPS. The LECs' overwhelming market dominance and the CAPs' utter lack of market power should end any debate on this subissue.

M. Baseline Issue 10: The Commission Should Not At This Time Revise The Approach That It Uses To Evaluate Petitions For Waiver Of The Price Caps Rules In Connection With Mergers And Acquisitions Of Exchange Properties.

There is some evidence that LECs have learned to maximize the value of exchange properties, perhaps in ways not intended by the Commission when it adopted its high cost exchange support rules. For example, some exchanges may be worth more to a price caps LEC if such exchanges are sold to a smaller LEC which qualifies for high cost exchange support. The Commission should examine this possibility carefully. While the Commission should not modify its price caps rules relative to this subject at this time, it should expeditiously initiate a comprehensive review of its Access Charge and Separations Rules, including high cost exchange support mechanism, and in that process consider whether the price cap rules should be revised to account better for mergers and acquisitions and the sale and swaps of exchange properties.

N. Transitional Issues: The Commission Should Not Make Changes To Its Price Caps Rules Based On A Perception That The Access Service Market Is Effectively Competitive; Such A Perception Would Be Inaccurate.

The NPRM seeks comment on a number of transitional issues, issues which apparently are predicated on the perception that the local exchange and access service markets may be on the verge of becoming effectively competitive. The Ad Hoc Committee believes such perception, assuming such perception exists, to be fundamentally wrong. Niche competition does exist in certain localities; it, however, is far from pervasive. Indeed, as explained in the ETI Analysis, the competition which today exists is quite limited, and is likely to remain limited for the foreseeable future.[32/] Therefore, a major overhaul of the price caps rules in contemplation of significant local exchange/access service competition is at least premature.

When, and if, competition becomes sufficiently widespread, the Commission could consider moving individual services out of price caps, rather than tinkering with the service mix in a particular functional basket. If effective competition in a specific service market is not ubiquitous, but is vigorous in more isolated circumstances, the Commission could consider narrowly targeted waiver requests. Proponents of such waivers should be required to demonstrate persuasively that the waiver requests will not produce cross-subsidization or discriminatory effects which would be anti-competitive. They also should be required to prove that the conditions which are the subjects of the waiver requests are narrow and appropriate for waiver.

The LECs' market dominance is also reason for the Commission to continue its triennial review of the performance of its LEC price caps rules. Triennial review is appropriate to assure that the price caps rules are serving the Commission's goals. For example, the ETI Analysis demonstrates that the current productivity factor was too low when it was prescribed over three years ago and will allow, unless increased, the LECs to enjoy

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[32/] ETI Analysis, pp. 90-101.

profit levels and, perhaps more importantly, cash flows which they would not be able to retain in a market that is effectively competitive.[33] In an industry marked by declining costs, it would be unreasonable for the Commission to abandon the triennial reviews. End users would suffer by paying excessive rates, and emerging competition would be jeopardized because of the LECs' ability to fund entry into new markets and to meet new competition through the cash flows and earnings which an improperly specified price caps plan would produce.

III. CONCLUSION

The LECs price caps rules need to be revised (through increasing the productivity factor); they should not be virtually abandoned. LECs continue to possess market power. Until the LECs lose their dominant position, the Commission should continue to periodically review its LEC price caps rules so that those rules produce conditions which mimic as close as possible the competitive condition. The Commission should also view its LEC price caps rules as an important tool to use to facilitate the development of competition in the local exchange and access service markets. The Commission would commit an error of profound proportions if through adjustments to the price caps rules it gives the LECs an advantage in building the information infrastructure of the future. LECS should not be allowed to earn more (indeed, quite the opposite), or keep more of what they

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[33] ETI Analysis, pp. 47-70.

earn. Nor should the Commission give the LECs greater general pricing flexibility or the ability to offer new services without previously filing sufficiently detailed cost support. The Commission should adopt a Report and Order in this proceeding which is consistent with the positions advocated herein.

Respectfully submitted,

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ATTACHMENT A

LEC PRICE CAP REGULATION: FIXING THE PROBLEMS AND FULFILLING THE PROMISE

ANALYSIS OF ISSUES: FCC PRICE CAP PERFORMANCE REVIEW FOR LOCAL EXCHANGE CARRIERS

CC Docket 94-1

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